EQUILON
ENTERPRISES LLC
Shell & Texaco Working Together

April 3, 1998

Mr. David S. Guzy
Chief, Rules and Procedures Staff
U.S. Department of the Interior
Minerals Management Service
Royalty Management Program
Rules and Publications Staff, MS 3101
Building 85, Denver Federal Center, Room A-212
Denver, Colorado 80225-0165

Re: *Supplementary Proposed Rule for Establishing Oil Value for Royalty Due on Federal Leases*

Dear Mr. Guzy:

Equilon Enterprises LLC ("Equilon") appreciates the opportunity to submit these comments on the Supplementary Proposed Rule for Establishing Oil Value for Royalty Due on Federal Leases that was published in the Federal Register on February 6, 1998 (63 Fed. Reg. 6112). Equilon is a joint venture between Texaco Inc. and Shell Oil Company, and would, under the supplementary proposed rule, be considered an "affiliate" of both Texaco Exploration and Production Inc. ("TEPI") and various Shell producing entities.

Equilon is engaged in the business of purchasing, trading, and selling crude oil, and operation of transportation, blending, and storage assets. Equilon does not engage in crude oil production on Federal or Indian lands; it does not own any Federal or Indian oil or condensate leases or properties; and it is not a party to any Federal or Indian crude oil leases. Including our transportation subsidiaries, we have facilities and operations in twenty-three states, including Alabama, Arkansas, California, Colorado, Delaware, Florida, Illinois, Indiana, Kansas, Louisiana, Michigan, Mississippi, Missouri, Montana, Nebraska, New Mexico, North Dakota, Oklahoma, Oregon, Texas, Utah, Washington, and Wyoming, and the Outer Continental Shelf. We purchase crude oil from producers in approximately nineteen different states, namely Alaska, Alabama, California, Colorado, Florida, Illinois, Kansas, Louisiana, Mississippi, Montana, North Dakota, Nebraska, New Mexico, Nevada, Oklahoma, South Dakota, Texas, Utah, and Wyoming, and the Outer Continental Shelf; and sell crude oil to refiners and resellers in those states.

In the crude oil trading business, Equilon maintains storage at most major market centers. At the lease, Equilon buys crude oil from TEPI, from the various Shell entities, and from non-affiliated third parties. Equilon also buys crude oil in bulk quantities at market centers and at other locations, including both aggregation points and non-aggregations points. Equilon sells crude oil at market centers and elsewhere, exchanges crude oil from one aggregation point to another, from aggregation points to market centers, from one market center to another, and from points that are neither aggregation points nor market centers to other points that are neither aggregation points or market centers. Equilon's customers include its affiliated refining companies, non-affiliated refining companies, and non-affiliated bulk oil purchasers. The crude oil that Equilon buys and sells is transported on wholly-owned crude oil pipelines, partially-owed crude oil lines (including both lines that it operates and lines that are operated by others), and on lines in which it has no ownership interest.

After Equilon purchases Federal lease crude from TEPI or the Shell producing entities, it adds substantial non-royalty bearing value before refining the crude oil or reselling it downstream to third parties. Such added value typically consists of crude location availability services, such as location exchange, transportation, terminaling, and storage; blending services to suit customer supply; and risk management requirements. These services both change the composition of the crude oil and increase its value downstream of the field in which it was produced. Equilon assumes significant risks, *e.g.*, the risks of spills, line loss, price volatility between the dates of purchase and delivery, exposure to environmental liability, credit risks, changes in customer demand or location differentials, and other marketplace risks in reselling the crude oil. The value arising from these downstream operations would not be reflected in the price of the crude in the field, regardless of whether the lessee sells the crude to an affiliate or unaffiliated party.

I. MMS IS IMPROPERLY ATTEMPTING TO REGULATE AN INDUSTRY WITH WHICH IT IS NOT IN CONTRACT

In order to comply with the supplementary proposed rule, companies like Equilon, who are affiliates of Federal lessees, would have to make dramatic changes in their operations and record-keeping practices. For example, under the supplementary proposed rule, Equilon's pipelines would have to track, and report to each of the co-owners, the "actual costs" for each co-owner. These "actual costs" would, under the supplementary proposed rule, vary based on the party's ownership interest, capacity rights, depreciation, and volume transported. Equilon's pipeline entities do not currently have or maintain this information. Furthermore, Equilon may be prohibited by the Interstate Commerce Act from providing some of the information required by the supplementary proposed rule. Specifically, Equilon is prohibited by 49 U.S.C.

§ 16103(a) from "knowingly disclosing to another person, except the shipper or consignee . . . information about the nature, kind, quantity, destination, consignee, or routing or property tendered or delivered to that carrier . . . ."

The supplementary proposed rule would effectively control the pricing, transportation and contracting behavior of Equilon, an entity that is not a party to any lease agreement with MMS. Through the supplementary proposed rule, MMS seeks to control Equilon's behavior not only with regard to its potential contracts with its lessee affiliates, but also its agreements with third-party transporters, pipelines and purchasers. Because Equilon has not entered into any agreement with MMS, the proposed rule improperly regulates Equilon's business and is outside the scope of MMS's statutory authority.

Initially, Equilon notes that MMS does not have the power to unilaterally alter its contracts with Federal lessees, let alone third parties. As discussed fully in the comments submitted by Texaco Inc. in response to the January, 1997 Proposed Rule for Establishing Oil Value for Royalty Due on Federal Leases, when the government seeks to abrogate the essential bargain of its contracts, such abrogation is an impermissible repudiation. *See, e.g., United States v. Winstar Corp.*, 116 S.Ct. 2432, 2479 (1996) (Scalia, J., concurring); *Lynch v. United States*, 292 U.S. 571, 578-80 (1934). Clearly, if MMS lacks the authority to unilaterally alter the terms of contracts it has itself consummated, it logically follows that it lacks the authority to unilaterally alter the terms and conditions of contracts to which it is not a party. Courts in a variety of contexts have similarly held. *See, e.g., Foxglenn Investors Limited Partnership v. Cisneros*, 35 F.3d 947, 951 (4th Cir. 1994); *Texas & New Orleans RR Co. v. Brotherhood of Railroad Trainmen*, 307 F.2d 151, 159 (5th Cir. 1962); *In re Taylor*, 96 Bankr. 584, 591 (E.D. Pa. 1989).

Furthermore, by purporting to regulate the conduct of an entity with which it has not entered into an oil and gas lease, MMS has exceeded the statutory authority delegated to it by Congress through the Federal Oil and Gas Royalty Management Act and similar statutes. Regulations can have the force and effect of law only if they are promulgated pursuant to a statutory grant of authority. *See Chrysler Corp. v. Brown*, 441 U.S. 281, 308 (1979). The only section of FOGRMA, for example, which applies to a party other than a lessee provides that a "lessee, operator, or other person directly involved in developing, producing, transporting, purchasing or selling oil or gas. . . through the point of first sale or the point of royalty computation," is subject to certain recordkeeping requirements. 30 U.S.C. § 1713(a). MMS's authority to control the non-recordkeeping conduct of an entity by "establish[ing] a comprehensive inspection, collection and fiscal and production accounting and auditing system to . . .accurately determine oil and gas royalties, interest, fines, penalties, fees, deposits and other payments owed,. . . " extends only to those entities responsible for paying royalties. *See* 33 U.S.C. § 1711(a). Regulating the conduct of a non-lessee, non-royalty payor like

Equilon is not only unnecessary to accomplish MMS's statutorily delegated goals, but is also beyond its authority. *See, e.g., ARCO Oil & Gas Co. v. FERC*, 932 F.2d 1501, 1503 (D.C. Cir. 1991) (Because FERC's authority extended only to the regulation of transportation, its regulation of non-transportation related contracts was suspect).

II. THE SUPPLEMENTARY PROPOSED RULE CONFLICTS WITH ANTITRUST POLICY

Compliance with the supplementary proposed rule could expose Equilon to unreasonable allegations of antitrust violations, because it would require "affiliates" that are independent companies to obtain current pricing information from each other where there is otherwise no independent business reason for doing so in order to track federal lease production to its "ultimate disposition" and compute the "actual costs" of transportation, as those terms are defined in the supplementary proposed rule. Plaintiffs lawyers might try to concoct a claim that an exchange of current pricing information such as that envisioned by the proposal somehow raises an inference of unlawful conspiracy under the Sherman Act, 15 U.S.C. § 1. An agreement to exchange current pricing information that has the effect of stabilizing prices and has an anticompetitive effect on the market, has been held to be a violation of the Sherman Act. *See United States v. Container Corp.*, 393 U.S. 333, 337 (1969). The petroleum industry has been a victim of such allegations in the past. *See, e.g., In re Pretrial Proceedings in Petroleum Products Antitrust Litigation*, 906 F.2d 432, 449 (9th Cir. 1990); *King & King Enterprises v. Champlin Petroleum Co.*, 657 F.2d 1147, 1152 (11th Cir. 1981). Allegations of antitrust violations not only result in protracted litigation, but liability carries the possibility of penalties and treble damages. 15 U.S.C. § 1 (penalties), § 15 (treble damages). While the requisite "agreement to exchange information" as was found in *Container*, 393 U.S. at 337, is not present here, because it is superseded by the legal requirement imposed by the supplementary proposed rule, compliance with the proposed rule could nevertheless expose Equilon to needless risk and costly litigation.

III. THE SUPPLEMENTARY PROPOSED RULE CONFLICTS WITH STATUTORY NON-DISCRIMINATION REQUIREMENTS

By limiting net-back adjustments for transportation services to certain "actual costs" in many circumstances, integrated companies would be denied the opportunity to recover the price normally charged in arm's-length transactions for those services. Non-integrated competitors, on the other hand, could deduct the full price of transportation services provided by third parties under the proposed rule. The differences, often substantial, between "actual costs" and the full market value of transportation services will vary from place to place, pipeline to pipeline, and company to company.

Without even considering the shortcomings of the proposed formulae as a basis for valuation, the proposed transportation allowance effectively requires integrated lessees to move Federal oil at a rate substantially lower than that provided for movement of third party production, even if it is moved through the same pipeline on the same day. This result is plainly in conflict with the Secretary's obligation, under the Outer Continental Shelf Lands Act, to grant pipeline rights of way on the express condition that "oil or gas pipelines shall transport or purchase *without discrimination*, oil or natural gas produced from submerged lands or Outer Continental Shelf lands in the vicinity of the pipelines . . . ." 43 U.S.C. § 1334(e). It also conflicts with the pipeline's obligation to provide "open and nondiscriminatory access to both owner and nonowner shipments." 43 U.S.C. § 1334(f). As well, it conflicts with the Interstate Commerce Act's prohibition against covered, common carrier pipelines from discriminating in favor of one shipper over other shippers. *See* 49 U.S.C. § 15501.

IV. THE SUPPLEMENTARY PROPOSED RULE WOULD IMPOSE AN ENORMOUS ADMINISTRATIVE COST ON THE AFFILIATES AND DESIGNEES OF FEDERAL LESSEES

A. Establishing "Customized" Valuation Methodologies Needlessly Complicates Royalty Valuation, Reduces Certainty, and Increases Costs

The supplementary proposed rule would require lessees with nationwide operations, and non-lessee companies that pay royalties on behalf of others, to establish at least four different valuation methodologies, the application of which would depend on the location of the lease, the ultimate disposition of the lease production, and a contract-by-contract analysis of arm's-length exchanges. Separate computer systems may be necessary to maintain and calculate different prices for the three different geographical areas. Developing these computer systems would require large start up costs, and there would also be continuing added costs to maintain three different computer systems. The costs of establishing and maintaining such a system would be enormous, and, industry-wide, may even exceed the amount of increased royalties that would result from the supplementary proposed rule.

B. Compliance With the Supplementary Proposed Rule May Be Impossible, Because it is Generally Not Possible to Track the Ultimate Disposition of Federal Lease Production or Crude Oil Received in Exchange for Federal Lease Production

Lessees would be required under the supplementary proposed rule to determine the "ultimate" disposition of each barrel of lease production. However, once crude oil is commingled there is simply no way to distinguish between Federal and non-Federal oil, or between Federal oil from different leases. Therefore, it is generally not possible to trace the ultimate disposition of Federal lease production, or of oil received in exchange for Federal lease production. Rather, some allocation methodology would be required, which, of course, reduces certainty. The supplementary proposed rule fails to offer any guidance on what allocation methodologies (*e.g.*, first in first out, last in first out, first in last out, etc.) would be acceptable to MMS. Allocation also presents problems in determining the quality of Federal lease production.

To correctly pay royalty on a barrel of oil under the supplementary proposed rule, Equilon's lessee affiliates would need to have the information regarding the final disposition of every barrel that Equilon bought, sold, or exchanged during the production month, as well as the methods of transport and the "actual cost" (as defined by the supplementary proposed rule) of that transportation. Equilon's accounting system does not come anywhere close to capturing the type of information required to comply with the supplementary proposed rule.

For the same reason, computing "actual costs" of transportation under the proposed section 206.111 would be extraordinarily difficult, if not impossible. For example, when Equilon purchases its affiliates' Federal lease crude production, it generally commingles the oil with oil purchased from other producers and other affiliates' Federal leases. Once the oil is commingled, it cannot be traced to downstream sales transactions. In addition, there are multiple delivery points within Equilon's pipeline system, which further complicates any attempt to allocate transportation costs. Equilon's accounting system was not designed to capture lease specific volumes and associated transportation costs for each barrel. It is impossible to assign an actual transportation cost associated with particular downstream resale contracts to barrels sold to Equilon from a Federal lease or from any other property. Consequently, it would be impossible for Equilon's affiliates to properly calculate their "non-arm's-length" transportation costs.

Compliance with the supplementary proposed rule, even if compliance were possible, would require that Equilon implement a new accounting system and devote additional manpower to attempting to track and record the use or disposition of the federal lease production it purchases. The proposal would also require dual record-keeping, because Equilon has no independent business need to maintain records on "actual costs" as defined by MMS.

C. MMS Has Grossly Underestimated the Cost that the Supplementary Proposed Rule Would Impose on Industry

MMS has failed to consider the cost that the supplementary rule would impose on the downstream affiliates of Federal lessees. Trying to trace, even by some allocation method, the ultimate disposition or use of every barrel of Federal lease production purchased from an affiliate would be extraordinarily time-consuming and expensive. It would also be necessary for Equilon to modify or replace its computer systems to provide the information required under the supplementary proposed rule. We estimate that the cost of implementing just the proposed Form MMS-4415 alone would be approximately $700,000, based on one affiliate. It would cost even more than that to modify or replace our computer systems to provide the information our affiliates would need to complete the MMS-2014. There may not be any amount of money that could generate accurate data required by the proposal.

V. VALUING OIL BASED ON THE DISPOSITION BY DESIGNEES OR THEIR AFFILIATES WOULD RESULT IN MARKETPLACE INEFFICIENCIES

Under proposed section 206.100(a), designees who do not dispose of lessees' oil must determine and report value for the lessees' oil by applying the rules to the lessees' ultimate disposition of their oil. This proposal would impose a significant and costly administrative burden on Equilon. If Equilon is the designee for several different interest owners, and does not dispose of their oil, it would have to make several different valuations based on what individual interest owners do with their oil. Moreover, determining and reporting the value for the lessees' oil would require access to information that Equilon does not currently have or maintain.

The supplementary proposed rule may also cause current designees to cease purchasing Federal oil from the various interest owners. Because of the expansive new definitions in proposed section 206.101, even arm's-length sales from joint operating agreement owners to a designee's affiliate would be valued at the designee's affiliate's downstream resale price. Hence, joint operating agreement owners would likely be reluctant to sell to their designee's affiliates. If the interest owners sell their own oil, it would be even more difficult for designees to properly report royalty values, because the supplementary proposed rule would require tracking each interest owner's oil to its ultimate disposition.

If the supplementary proposed rule is implemented, non-lessee companies like Equilon may be forced to cease paying Federal royalties on behalf of others. Because we have a nationwide operation, compliance with the proposed valuation methodologies would require three separate computer systems. Hence, it would be cost-prohibitive to continue paying royalties on behalf of others.

VI. MMS LACKS STATUTORY AUTHORITY TO REQUIRE LESSEESÍ AFFILIATES TO MAINTAIN OR MAKE AVAILABLE FOR MMS AUDIT ANY RECORDS OF DOWNSTREAM TRANSACTIONS

The supplementary proposed rule purports to require Federal lessees and their affiliates to track Federal lease production through multiple non-arm's-length transactions until the oil is ultimately refined by an affiliate or sold at arm's-length to a nonaffiliated party. Proposed section 206.102 also looks beyond arm's-length exchange agreements to require Federal lessee to track the disposition of oil received in exchange for Federal lease production through one or more arm's-length exchange agreements. Both aspects of the supplementary proposed rule exceed the Secretary's statutory authority. Section 103(a) of the Federal Oil and Gas Royalty Simplification and Fairness Act of 1996 ("FOGRMA") provides, in pertinent part, that:

> A lessee, operator, or other person directly involved in developing, producing, transporting, purchasing, or selling oil or gas subject to this Act through the point of first sale or point of royalty computation, whichever is later, shall establish and maintain any records, make any reports, and provide any information that the Secretary may, by rule, reasonably require for the purposes of implementing this Act or determining compliance with rules or orders under this Act.

30 U.S.C. § 1713(a). In construing this provision, the Interior Board of Land Appeals ("IBLA"), as affirmed by the United States District Court for the District of Delaware, and the United States Court of Appeals for the Tenth Circuit have held that MMS can require the production of records from those directly involved in the *first* purchase of Federal oil or gas. *See Santa Fe Energy Products Co. v. McCutcheon*, 90 F.3d 409, 414 (10th Cir. 1996)(concluding that, because lessee's affiliate was a "person directly involved in . . . purchasing . . . oil or gas subject to this chapter through the point of first sale or royalty computation," MMS could require the affiliate to establish and maintain records and make reports); *Shell Oil Co. v. Department of the Interior*, 945 F. Supp. 792, 800 n.7 (D. Del. 1996)("FOGRMA is . . . limited to persons "directly involved" in transactions of oil or gas from Federal leases"). No case has ever held that MMS can require those who are not directly involved in the first sale of Federal lease production to establish and maintain records or make reports. Nor is there any authority for MMS to require anyone -- lessees or first purchasers -- to establish and maintain records and make reports relating to nonlease oil *received in exchange* for Federal lease production.

FOGRMA does not limit the term "first sale," as the supplementary proposed rule does, to the first arm's-length, outright sale between nonaffiliated parties. Equilon's purchases from its affiliates involve *sales* of crude oil, not transfers. Title transfers from the affiliate to Equilon, and Equilon pays valuable consideration for the crude oil. Similarly, Equilon's buy/sell transactions with third parties are *sales*. Indeed, MMS's own Oil and Gas Payor Handbook recognizes that exchange agreements and buy/sell transactions are sales. Volume III, Product Valuation, Section 3.3, Oil Exchange Agreements, explains that: "The exchange agreement represents two distinct sales under the contract and the value of lease production is determined at the first point of sale (the first exchange point)."

While MMS may have the authority to impose recordkeeping regulations on both parties to the first sale of Federal lease production, it lacks authority to impose any recordkeeping obligation beyond the first sale, or on anyone not directly involved in the first sale. It follows, therefore, that MMS cannot require lessees to track Federal lease production to its "ultimate disposition." Nor can MMS require lessees, much less their affiliates, to track oil received in exchange for Federal lease production.

VII. CONCLUSION

The supplementary proposed rule would harm Equilon's business and the marketplace efficiencies we create. We therefore urge MMS to withdraw the proposed rule. MMS should retain the long-standing principle of valuing crude oil at the lease, and not improperly attempt to regulate an industry over which it lacks statutory or contractual control.

Sincerely yours,

C L Persyn

Chuck L. Persyn